ECONOMICS

OMB, CBO and private economic forecasts have all improved notably since last summer. Several inter-related factors are at play: (1) the short-term outlook is much stronger than most had anticipated last year; (2) underlying productivity growth has picked up in recent years; and (3) technical revisions by the Bureau of Economic Analysis boosted GDP level and growth rates. The first two factors had the greatest impact on revenue estimates. Improved economics boost OMB's surplus projections by a cumulative $371 billion over the next five years. CBO's improved economics lead to a $271 billion improvement over the same period.

OMB's and CBO's economic forecasts are fairly similar overall, and are less optimistic than private forecasters.

I : Economic Overview

Despite the fact that the present expansion is now the longest on record, the economy is showing few signs of slowing. Real GDP has grown in excess of four percent for each of the last three years and retains considerable momentum into 2000. Indeed, this supercharged growth has raised concerns that the economy may be overheating, given growing imbalances in the labor market and the US external position. In response to such concerns, the Federal Reserve has embarked on a tightening path designed to return the economy to its long-run sustainable growth rate and to head-off a build-up in inflationary pressures.

Will the Federal Reserve be able to pull-off a soft landing that would ease growth back to its trend rate, without precipitating a sharp downturn along the way? Most economists believe that they will, given the Fed's success in 1994 and 1995 during a similar episode. As such, both OMB and CBO assume a soft landing scenario in their projections.

II : Comparison of OMB's Economics Versus CBO's

OMB's and CBO's economic forecasts are similar and are within the range of error on these forecasts. Both look for the economy to slow below its potential growth rate over the next few years, while inflation increases slightly. Neither expects a recession. OMB and CBO have essentially the same average real GDP growth over the next five and ten years, while OMB projects slightly faster nominal GDP growth, higher interest rates and smaller highly-taxed income shares than CBO.

Both OMB and CBO take cyclical considerations into account for 2000 and 2001, and make out-year projections based on the underlying trends in the economy. These latter projections assume that the risks of recession and boom are equally weighted.

Growth

OMB and CBO expect that the economy will slow over the next few years, as consumer spending decelerates (due to an expected slowdown in employment growth and stock market appreciation) and as interest rate sensitive sectors respond to the recent upturn in interest rates.

From 1999-2004, OMB and CBO expect virtually the same average annual real GDP growth – 2.81 percent for OMB, 2.85 percent for CBO. In contrast, most private forecasters (DRI, WEFA) expect real GDP growth to top 3 percent over this same period. Within the five-year window, CBO expects slightly faster growth in 2001-03 than OMB, and slightly slower from 2004-2005.

Private forecasters also project a higher level of nominal GDP than either OMB or CBO. (Nominal GDP is more important than real GDP from a budget perspective, since the former is the basis for tax projections.) Despite having nearly identical real GDP projections, OMB assumes higher nominal GDP than CBO – OMB's is $182 billion higher by 2005 and $447 billion (roughly 3 percent of GDP) by 2010 above CBO's. As a consequence, OMB's nominal GDP growth rate is 0.3 percentage points faster than CBO's over both the five and ten-year window. While this assumption helps OMB's revenue projections, the revenue effect is partially offset by OMB's more pessimistic income share assumptions (discussed below) .

Inflation

Both OMB and CBO expect that inflation will pick-up slightly from this year's pace, in deference to tight labor markets and a waning of temporary factors that had been restraining prices up to this point (ie, the strengthening dollar and plunging commodity prices).

Both OMB and CBO project largely the same CPI growth over the budget window -- OMB expects 2.6 percent, while CBO expects 2.5 percent.

There is greater difference on their GDP deflator projections. CBO looks for the deflator to average 1.7 percent over most of the budget window, while OMB expects it to be 2 percent. The higher the deflator, the higher nominal GDP and hence projected tax revenues.

Income Shares

Income shares are a less publicized portion of the forecasts, although they can have key budgetary effects. Income shares depict the breakdown of national income between wages and salaries, benefits, corporate profits, proprietors' income, rental income and net interest. They are expressed as a share of GDP.

If all of the above were taxed the same, the division between income categories would make little budgetary difference. Yet, this is not the case. Wages & salaries and corporate profits are taxed at a higher effective tax rate -- as such, the higher they are relative to the other income categories, the higher the projected revenue stream. These latter two categories are termed the highly taxed shares.

OMB and CBO both expect the highly taxed share to decline over the budget window, due to expected rapid growth of depreciation, higher interest rates and an increase in benefit costs. However, OMB expects a steeper decline over both the five and ten-year period. The lower the income share, the lower the revenues. OMB's more pessimistic income share assumptions partially offset the revenue effects of their more optimistic nominal GDP stream.

Interest Rates

Both OMB and CBO expect higher interest rates over the next few years, given Wall Street's expectations of further Fed tightening in coming months. CBO assumes slightly higher short and long term interest rates than OMB until 2002, after which CBO assumes interest rates trend down toward their 1999 level. In contrast, OMB assumes that interest rates remain at elevated levels throughout the 10 year window, thus ensuring that their rates are slightly higher than CBO's from 2003 onward. Higher interest rates erode surplus projections since they raise debt service costs.

III: Sensitivity to Economic Changes

With imbalances growing in the labor market and the Fed embarking on a tightening cycle, one might wonder what could happen to budget projections if a soft landing turns into a hard landing despite the Fed's best efforts. In its latest update, CBO looked at the possible impact of a boom/bust cycle on their budget projections. Interestingly, while there were notable year-to-year effects, CBO's cumulative 10-year surplus projections were little affected. In CBO's exercise, surpluses rose above current projections in the near-term boom period, but slipped below baseline projections in 2003 when the bust was assumed to begin. At the recession's nadir in 2005, that year's surplus fell $100 billion under projection. However, by 2007, surpluses were back at currently projected levels.

This is not to say that the current 10-year cumulative surpluses are written in stone. CBO also modeled cases where they varied their structural assumptions about trend growth, personal income tax receipts, and Medicare/Medicaid spending. If all these factors improved relative to current assumptions, projected 10-year surpluses would roughly double. Equally, if these assumptions all deteriorated, the projected surpluses would vanish altogether. While it is unlikely that all of these factors would move in lock-step as in this exercise, it does highlight the inherent variability of surplus projections. However, it is important to note that there are risks to both the upside and downside, not just the downside as some have asserted.

IV : Long-Term Outlook

At present, there has been considerable discussion as to what happens to the publicly held debt under various budget scenarios. The President says that his plan will pay off the debt by 2013. Under CBO's baseline, the Senate Budget Committee estimates that "just" saving the Social Security surplus would pay off the debt by roughly the same year. Thus, given widespread commitment to save Social Security's funds, Congress would also pay-off the debt by roughly 2013.

While the fiscal outlook is certainly very good out to 2013, what happens afterwards when the baby-boom generation has retired? The common consensus is that US finances will deteriorate markedly by the middle of the century, with debt returning and eventually surging to unsustainable levels above 150 percent of GDP. This was the result of the latest CBO long-term fiscal study, which was done using the July baseline. GAO and other private modelers have reached similar conclusions.

The outlier is OMB. In the latest update of its long-term fiscal model, it shows the US in a sustainable long-term position for the next 75 years. Most find these results very odd. What accounts for their results? OMB assumes that discretionary spending falls very sharply as a share of GDP over this period, thus absorbing some of the growth of rapidly expanding entitlement programs. Furthermore, OMB does not have economic feedbacks in their model, which limit the compounding of negative effects from any debt buildup. This sanguine long-term result may be the reason that the Administration appears to feel little urgency to make substantive reforms to Social Security and Medicare.

ECONOMIC PROJECTIONS COMPARISON
(Calendar Years)

		1999	2000	2001	2002	2003200420 05	
% Change (Year to Year):							
Nominal GDP Growth							
Administration*	5.4	4.9	4.9	4.6	4.6	4.95.1	
CBO*		5.4	5.0	4.8	4.5	4.34.34.4	
Blue Chip*	5.4	5.3	4.9	—	—	—	—
Real GDP Growth							
Administration	3.9	3.3	2.7	2.5	2.5	2.83.0	
CBO		3.9	3.3	3.1	2.8	2.62.62.7	
Blue Chip	3.9	3.6	3.0	2.4	2.8	3.02.9	
Consumer Price Index							

Administration	2.2	2.6	2.4	2.6	2.6	2.62.6
CBO		2.2	2.5	2.4	2.5	2.52.52.5
Blue Chip	2.2	2.5	2.5	2.6	2.4	2.42.3
GDP Price Index						
Administration	1.4	1.6	2.0	2.0	2.0	2.02.0
CBO		1.4	1.6	1.6	1.7	1.71.71.7
Blue Chip	1.4	1.7	1.9	2.1	2.0	2.01.9
Annual Rate:						
Unemployment						
Administration	4.2	4.2	4.5	5.0	5.2	5.25.2
CBO		4.2	4.1	4.2	4.4	4.74.85.0
Blue Chip	4.2	4.1	4.3	—	—	——
Three-Month T-Bill						
Administration	4.7	5.2	5.2	5.2	5.2	5.25.2
CBO		4.6	5.4	5.6	5.3	4.94.84.8
Blue Chip	4.6	5.6	5.6	5.0	4.7	4.74.7
Ten-Year T-Note						
Administration	5.6	6.1	6.1	6.1	6.1	6.16.1
CBO		5.6	6.3	6.4	6.1	5.85.75.7
Blue Chip	5.6	6.4	6.3	5.7	5.5	5.65.5
Share of GDP:						
Corporate Profits						
Administration	9.2	8.7	8.2	7.8	7.4	7.37.3
CBO		9.1	8.6	8.2	7.8	7.67.47.3
Wage and Salaries						
Administration	48.4	48.6	48.7	48.6	48.5	48.348.2
CBO		48.5	48.8	48.8	48.9	48.948.948.9

*President's FY 2001 Budget; CBO's "Economic and Budget Outlook: Fiscal Years 2001 - 2010"; Blue Chip January 2000 Economic Indicators for 2000 and 2001, Blue Chip December Financial Indicators for 2002-2005.